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Book Review: THE MARITAL DEDUCTION AND THE USE OF FORMULA PROVISION. By Richard B. Covey

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BOOK REVIEWS

THE MARITAL DEDUCTION AND THE USE OF FORMULA PROVISION. By *Richard B. Covey*. Pp. 115. Bobbs-Merrill Co., Inc., Indianapolis, 1966. \$7.50.

According to the preface, the author's purpose in preparing this slender volume is based on a conviction that a majority of lawyers using formula clauses, and also some courts do not adequately understand the operation of such provisions. The author thinks this condition might be attributable, at least in part, to "... the lack of any published comprehensive analysis of the subject matter. It is hoped that this short book will fill the void."¹ In the reviewer's opinion this lack of understanding is due, in part, to the fact that general practitioners only have occasional opportunities to use formula clauses, since the bulk of their estate planning is in connection with smaller estates where the use of a formula provision with its attendant complexities may not be justified,² and it is questionable whether such a specialized volume as this would be purchased or, even if otherwise available, used by a general practitioner. The book is likely to prove more helpful to an attorney who uses formula clauses frequently but does not have sufficient experience, actual or vicarious, with the administrative problems that arise under such provisions after the client dies and the dispositive instrument goes into effect. Even in some trust companies there may not be sufficient "interaction" between the division engaged in helping attorneys formulate estate plans and the administrative officers who have to put them into effect to supply this experience. The judicial decisions the author disapproves of might have been due to insufficient assistance from the briefs and oral arguments of the attorneys representing the litigants or to the infrequency with which such problems are presented to the courts. Since the author, as a New York lawyer, uses the law of that state as his "point of departure" and admits the citations to the law of other states are "obviously incomplete,"³ his book will be of most use to the New York lawyer and, because of differing state laws, it does not discuss many of the operational problems that can arise under formula clauses in other states.

The book consists of thirteen chapters and two appendixes, one containing suggested clauses and another setting forth Revenue Procedure 64-19 verbatim. A few comments will be offered on each.

The first chapter describes a formula clause generally, and its purpose. The author then refers to initial reservations lawyers had concerning the

1. Pp. v-vi.

2. The author believes that formula clauses are used more frequently in "... substantial estates (say in excess of \$200,000)..." (P. v.).

3. P. vi.

use of such clauses since the assets passing under these provisions were not definitely ascertainable as of the valuation date because the executor might elect to claim administration expenses as income tax deductions. While stating that fear of the loss of the marital deduction for this reason has proved groundless,⁴ it is unfortunate that the author did not deal with remarks made by a Treasury official in 1964 indicating that the marital deduction gifts might have to vest as of the testator's death, and posing the question of the effect of the executor's option to elect the alternate valuation date under the usual formula clause.⁵ This has caused enough concern to result in an American Bar Association subcommittee report which concludes that there is a sufficient vesting as of the testator's death.⁶ Such recent developments presumably will be covered in the promised annual supplements to the text.

The second chapter begins with a description of the two basic types of formula clauses, the legacy (dollar amount) and the fractional share of the residue. The difference between an after- and before-tax fractional share of the residue provision is illustrated and there is a careful discussion of the appropriate way of describing the denominator in such clauses. Appendix A contains suggested clauses for "outright" and "in trust" legacy and after-tax residue formula clauses. The author prefers not to refer to date of distribution values in the formula clauses themselves but would confine this language to the administrative provisions. The reviewer favors insertion of a statement that date of distribution values are to be used in the formula clauses themselves, so that in the event of litigation the court is more likely to see that estate tax values are to play only a limited role, *i.e.*, in the computation of the dollar amount in the case of a legacy clause and in setting up the fraction in a residue formula clause.

After emphasizing the importance of clearly indicating in the dispositive instrument which clause is intended, Chapter III continues with a discussion of problems arising under formula clauses subject to the New York estate tax law which also allows a marital deduction. However, in states with an inheritance tax and no marital deduction, the problems can be somewhat different than those described in the text. For example, where the federal estate tax is allowed as a state inheritance tax deduction, a recomputation of the federal estate tax may be required because of differing state treatment of a decedent's assets which, if it results in a different adjusted gross estate, can change the amount of the marital

4. Later there is mention of the possibility that the Treasury may decide to change its present position permitting an increase in the marital deduction as a result of such an election. P. 79, n.123.

5. Reiling, *A Chance to Rethink Marital Deduction Clauses*, 1964 Proceedings of the Probate and Trust Law Divisions, Section of Real Property, Probate and Trust Law of the American Bar Association, 10.

6. 1 *Real Property*, PROBATE AND TRUST JOURNAL 164 (1966).

deduction allowed in computing the federal estate tax deduction.⁷ The balance of this chapter contains an extensive discussion of the problems of allocating estate income during administration where the surviving spouse is not included as a beneficiary of the non-marital or family trust. While the author is to be commended here for discussing the law of states other than New York, a relatively inexperienced person may have difficulty following the textual treatment, since he must first discern that there is the problem of determining *when* the surviving spouse becomes entitled to income during administration and, if such right exists, there is the second and independent problem of determining *how much* income the surviving spouse is entitled to when a formula clause is involved. Drafting-wise, in this chapter and Appendix A, the author does suggest establishing the right to income as of the death of the first spouse to die (at least where there is any doubt under state law as to this matter), and also how the amount of income should be determined by the fiduciary.

Chapter IV deals with the problem of allocating gains and losses realized during administration under a fractional share of the residue formula clause where the residue is constituted either prior to or after tax payments. Appendix A contains two sample clauses as to how such gains and losses might be allocated, and with the textual discussion should be helpful to an attorney whose client is interested in reducing the amount of appreciation allocable to marital gifts.

Chapter V is concerned with distribution problems under a fractional share of the residue provision, emphasizing that a greater tracing problem may be involved if a pre-tax residue is used and, in any event, the difficulty of accomplishing a straight fractional split of each asset to which the fraction is theoretically applicable. The author appears to agree with Professor Casner that any deviation from such a split may result in undesired income tax consequences. It is worth noting that Revenue Procedure 64-19, set forth in Appendix B, does not purport to apply to fractional share clauses provided each beneficiary receives a proportionate share of appreciation or depreciation, but it specifically avoids dealing with any income tax consequences. However, in Chapter VI which deals with the income tax consequences of satisfying marital gifts, the author states that a fractional share clause avoids the capital gain or loss realization problems of legacy provisions, a statement which apparently assumes a straight fractional split is possible, or else that the Treasury has not yet taken seriously Professor Casner's suggestions where there is a non-prorata split. Since both types of formula clauses can carry out estate income, the author advises considering the use of a non-formula pecuniary legacy for part of the marital portion and satisfying fractional share gifts with appreciated assets.

7. See, e.g., Wis. Stat. § 72.015 (5) (1965); Estate of Stevens, 266 Wis. 331, 63 N.W.2d 732 (1954); Estate of Wanvig, 21 Wis. 2d 416, 124 N.W.2d 690 (1963).

Chapter VII contains an extensive discussion of Revenue Procedure 64-19, subsequent state legislative and judicial developments and drafting suggestions. As to state statutes requiring an equitable sharing in any appreciation or depreciation, absent an express contrary provision in the dispositive instrument, the author objects that this in effect converts a legacy into a fractional share provision which the decedent tried to avoid by the use of legacy language. But it might be pointed out in defense of such statutes that they codify the equitable approach used by courts in other jurisdictions which have passed on the problem and, unless the decedent was very knowledgeable, his objective may have been merely to avoid realization of gain or loss by satisfaction of legacy gifts at estate tax values. The author appears to favor drafting so as to use the minimum worth approach, although he admits it is not yet settled whether the "floor" involved in such a provision creates income tax problems.

A similar favoritism of the author is exhibited in Chapter VIII where a legacy funded at date of distribution values, the fractional share of the residue and the minimum worth formula clauses are compared. If the client is interested in reducing death taxes at the surviving spouse's death, the author prefers the minimum worth legacy provision. Unfortunately, in making these comparisons he does not consider the administrative problems involved in satisfying a legacy, which normally is the responsibility of the executor, where the decedent's insurance is payable to the testamentary trustee, as is permitted in a number of states including New York. That is, the funding must be done by the executor and some of the insurance (possibly a large amount) may be needed to satisfy the marital trust. Specifying in the insurance beneficiary designations how much insurance the testamentary trustee must allocate to the marital trust, creates the rigidity which the formula clause is designed to avoid, but leaving the amount up to the discretion of the trustee may create a problem as to whether the insurance really "passed" from the decedent to the surviving spouse. Here a fractional share clause appears to be simpler since the residue can be given to the trustee who then has the responsibility of funding the marital trust, and also has the insurance, a result which of course can also be accomplished through the use of a living insurance trust and a pourover will.

Chapter IX deals with special income tax differentials where a revocable trust with a pourover will is used (*i.e.*, determining when income is required to be distributed currently, the separate share and throwback rules, and disallowance of losses between related parties). This discussion is particularly timely now that these planning tools are advocated by a variety of persons, ranging from mutual fund salesmen to law school professors.

Chapter X is concerned with the desirability of drafting so as to forbid satisfaction of marital gifts with "tainted assets" and reducing formula

gifts not only by other assets passing to the surviving spouse which are included in the decedent's gross estate, but also which qualify for the marital deduction.⁸ The problem of excluding assets which qualify for the foreign death tax credit and which constitute income in respect of a decedent is also discussed here.

In Chapter XI the author considers not only the ramifications of the executor electing to claim administration expenses as income tax deductions and electing the alternate valuation date but also the effect of claiming medical expenses as income tax deductions and electing to accrue interest on Series E bonds. Appendix A contains a suggested omnibus clause covering all such elections and the problem of any resulting adjustments. Chapter XII deals with situations where the surviving spouse's estate is so large that it is desirable to avoid the marital deduction in the estate of the first to die, if the other spouse does not survive by more than six months.

In the concluding chapter the author demonstrates, at least to his own satisfaction, that the use of formula clauses is desirable. Psychologically, it may have been wise to end the textual discussion with an attempt to bolster the reader who has managed to survive the discussion in the preceding chapters, which at times is very intricate. In summary, the book offers valuable problem discussion and drafting suggestions for the attorney who already has substantial understanding of formula clauses but is likely to prove difficult reading fare for others.

*Leo W. Leary**

8. Where a death benefit, excludible under IRC Sec. 2039(c) is payable to a nontestamentary trustee, it is probably desirable to have it specifically payable to the non-marital or family trust, especially where a fractional share clause drafted so as to include non-testamentary assets is involved.

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